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No.

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1988

ARTHUR D. LITTLE, *et al.*,
PETITIONERS,

v.

RICHARD LESSLER,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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I

QUESTIONS PRESENTED

1. Whether an implied private right of action exists pursuant to which a shareholder may enforce Section 17(a) of the Investment Company Act of 1940, when Section 17(b) expressly confers on the Securities Exchange Commission the authority to regulate transactions subject to Section 17(a)?

2. Whether, in view of the dissonant approaches of the circuits, a private right of action should be implied in the Investment Company Act of 1940?

II

LIST OF PARTIES and RULE 28.1 LIST

The parties to the proceedings below were the petitioners Arthur D. Little, Robert D. Manchester, William P. Considine, John M. Fox, Frederick G. Frost, III, Harlow W. Gage, Norman E. McCulloch, Jr., John R. Rockwell, Harvey J. Sarles, Rosalie J. Wolf, Gregory P. Barber, Roger A. Vandenberg, Jonathan Nelson, Geraldine M. McNulty, Narragansett Management Company, Narragansett Capital Corporation, and Monarch Capital Corporation.[1]

The respondent before this Court is Richard Lessler.

[1] The subsidiaries and affiliates of Monarch Capital Corporation, other than those that are wholly owned, are: Associated Capital Investors, Inc. and WorldInvest Holdings, Ltd.

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ARTHUR D. LITTLE, *et al.*,
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RICHARD LESSLER,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

The petitioners Arthur D. Little, et al., respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit, entered in the above-entitled proceeding on September 19, 1988.

Opinions Below

The opinion of the Court of Appeals for the First Circuit is reported at 857 F.2d 866 (1st Cir. 1988), and is reprinted in the Appendix hereto, p. A-1, *infra*.

The Order and Judgment of the United States District Court for the District of Rhode Island (Pettine, D.J.) have not been reported. They are reprinted in the Appendix hereto, page A-36-37, *infra* along with the Magistrate's Report and Recommendation referenced therein.

Jurisdiction

Invoking federal jurisdiction under Section 44 of the Investment Company Act of 1940, 15 U.S.C. § 80a-43, and Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, the respondent brought this suit in the United States District Court for the District of Rhode Island. On December 4, 1987 judgment entered in the District Court dismissing plaintiff's amended complaint on the grounds that it failed to state a claim upon which relief could be granted and failed to plead fraud with particularity. Respondent appealed to the United States Court of Appeals for the First Circuit.

On September 19, 1988 the First Circuit affirmed in part and reversed in part the judgment of the district court. No petition for rehearing was sought.

The jurisdiction of this Court to review the judgment of the First Circuit is invoked under 28 U.S.C. § 1254(1).

Statutes Involved

15 U.S.C. § 80a-17(a). *Transactions of certain affiliated persons and underwriters.*

> (a) *Prohibited transactions.* It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 80a-12(d)(3)(A) and (B) of this title), or any affiliated person of such person, promoter, or principal underwriter, acting as principal—
>
> (1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or

(C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property for such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 21(b) of this title.

(b) *Application for exemption of proposed transaction from certain restrictions.* Notwithstanding subsection (a), any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of that subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this title; and

(3) the proposed transaction is consistent with the general purposes of this title.

Statement of the Case

Section 17(a) of the Investment Company Act of 1940 ("ICA") makes unlawful certain transactions between a mutual fund and its managers. The statute recognizes that in the mutual fund industry, management is typically externalized: underwriting, promotion, distribution, and investment is ordinarily performed by a fund's investment adviser. To guard against self-dealing and abuse of that close, interdependent relationship, section 17(a) prohibits the sale of a fund's assets to its affiliates.

Section 17(b) of the ICA confers upon the Securities and Exchange Commission ("SEC") the power to regulate transactions subject to the prohibitions of Section 17(a). The measure authorizes "any person" to seek an order from the Commission that exempts a proposed transaction from Section 17(a)'s reach. Consequently, and pursuant to its mandate, the SEC must in such circumstances determine (1) whether a proposed transaction falls within Section 17(a)'s ambit, (2) whether it constitutes a violation of that measure, and (3) whether the transaction is nevertheless fair and reasonable. The SEC's regulatory power appears from the language of the statute to be exclusive: The Commission may exempt the sale under Section 17(b) or it may sue to enjoin the violation. But the Investment Company Act by its terms provides no other express enforcement mechanism for alleged violations of Section 17(a).

This case tests whether private litigants may preempt the SEC's regulatory role, and thereby provoke potentially inconsistent results, by enforcing alleged violations of Section 17(a) in the federal courts. The issue presented by the implication of a private right of action for shareholders under Section 17(a) involves the balance achieved by Congress in its regulation of the mutual fund industry, and the threat posed to that balance by the interjection of judicially created remedies.

This issue arises out of a transaction involving three players: the mutual fund, Narragansett Capital Corporation ("Narragansett"); its investment adviser, Narragansett Management Company ("Management Company"); and Monarch Capital Corporation ("Monarch"), an unrelated third party. Narragansett sold its assets to Monarch, and Monarch executed a contract to have those assets managed by Management Company. The respondent Richard Lessler, a Narragansett stockholder, commenced this action in the United States Disrict Court for the District of Rhode Island challenging the sale of assets under the Investment Company Act, the Securities Exchange Act of 1934, and provisions of state law. Under the ICA, Lessler claimed that the agreement between Monarch and Management Company violated Section 17(a) because fees to be paid to Management Company by Monarch were "property" of Narragansett "purchased" from the fund by one of its "affiliates."

The district court dismissed the amended complaint for failure to state a claim upon which relief could be granted. The Court of Appeals for the First Circuit reversed that decision in part.[2] Without once referring to the actual language of Section 17(a), and without even adverting to the enforcement mechanism of Section 17(b), the Court held that a private right of action should be implied. The appellate court remanded the case for trial; the only federal question preserved for trial is whether Section 17(a) was violated.

Reasons for Granting the Writ

Without anchoring its analysis in the strict construction of congressional intent commanded by this Court, the Court of Appeals for the First Circuit has carved into section 17 of the Investment Company Act ("ICA" or the "Act") an implied

[2] The First Circuit affirmed the district court's judgment dismissing the plaintiff's claims under the Exchange Act and under Sections 36(b) and 47 of the ICA.

private right of action for damages. In so ruling, the Court of Appeals trespassed on the enforcement authority Congress expressly chose to vest in the Securities Exchange Commission ("SEC") and rendered a decision that threatens to create an untenable practical situation within the $1,200 billion mutual fund industry.[3]

Moreover, the First Circuit's opinion reflects the dissonance among lower federal courts concerning the implication of private rights of action under the ICA. In view of such varying approaches, and in view of the practical consequences to the mutual fund industry posed by the First Circuit's holding, the question that this Court specifically left open in *Burks* v. *Lasker*, 446 U.S. 471, 476 (1979), should be resolved.

Finally, the ruling below is in irreconcilable conflict with applicable decisions of this Court. The Court of Appeals' decision, grounded on the broad proposition that private rights of action may be implied under the ICA generally, is marked by its failure to adhere to this Court's guidelines.

I. The Court of Appeals' Implication of a Private Right of Action Under Section 17 of the Investment Company Act of 1940 Raises an Important Question of Federal Law That Should Be Decided by This Court.

A. *Congress Has Enacted a Comprehensive Scheme for the Regulation of Affiliated Party Transactions in the Mutual Fund Industry That Should Not Be Altered by the Addition of Judicially Inferred Remedies.*

The expansive approach to judicial implication of private rights under the ICA evidenced by the First Circuit—and by the decisions on which it principally relies—represents an unwarranted trespass on the enforcement authority Congress has chosen to repose in the SEC.

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[3] *See* 1987 Annual Report, U.S. Securities and Exchange Commission, at 49 (1988).

In *Daily Income Fund* v. *Fox*, 464 U.S. 523 (1984), this Court repeated its observation that the ICA was adopted because of congressional concern with "the potential for abuse inherent in the structure of investment companies." *Id.* at 536, *quoting Burks* v. *Lasker*, 441 U.S. 471, 480 (1979). The Court noted that Section 17 of the Act in particular was directed to this abuse potential. Because the management of funds is typically externalized, and conducted by the fund's investment adviser, Section 17 minimizes conflicts of interest by regulating transactions between investment companies and their advisers. *Daily Income Fund*, 464 U.S. at 536. Section 17(a) accordingly declares "unlawful" the "purchase" of "any . . . property" from a registered investment company by an "affiliated person or promoter . . . or underwriter" of such registered investment company. 15 U.S.C. § 80a-17(a).

In erecting an enforcement mechanism to regulate transactions within Section 17(a)'s reach, Congress recognized that the close, interdependent relationship between mutual funds and their advisers was likely to produce a volume of transactions that were essentially appropriate, but that nevertheless fell within the purview of Section 17(a). Section 17(b) therefore confers upon the Securities and Exchange Commission the power to regulate transactions subject to Section 17(a) by authorizing the issuance of exemption orders. The provisions must be read together: To protect against the "potential for abuse" noted by this Court, the proscriptions of Section 17(a) are deliberately broad; to compensate, Section 17(a) is a valve operated by the SEC through which reasonable and fair transactions between a fund and its adviser are permitted to flow.

"Purchases" of "property" from a fund by its adviser—statutorily prohibited but for Section 17(b)—range from the mundane to the extraordinary. Even incidental sales of property are within Section 17(a)'s reach, so that the daily relationship between a fund and its adviser can yield a "sale" of property. Fundamental transactions undertaken for the benefit

of a fund's security holders are likewise susceptible to characterization as a "purchase" of "property" by an "affiliate." The reorganization of a "family" of funds, for example, or the merger of funds promoted by a common adviser, are transactions that may fall within the ambit of Section 17(a).[4] The scope of transactions that can be shoehorned into Section 17(a) is wide; and thus the task of the Commission under Section Section 17(b) is complex, and one that requires a sophisticated understanding of the mutual fund industry.[5]

Section 17(b) is thus the principal weapon deployed by Congress to regulate potential conflicts of interest between a mutual fund and its investment adviser. By vesting power in the SEC to exempt transactions from Section 17(a)'s proscriptions, the statute defers to the expertise of an administrative agency to execute the mission Congress has assigned it. But Section 17(b) and its system of exemption orders is not the exclusive enforcement device that the ICA expressly makes available to the SEC. When an exemption order is *not* sought, the Commission nevertheless retains the power to enforce compliance with the prohibitions of Section 17(a). As it did in the Investment Advisers Act, which this Court has held is not privately enforceable, *Transamerica Mortgage Advisors* v. *Lewis*, 444 U.S. 11 (1979), Congress provided express mechanisms that also confer upon the Commission the exclusive power to regulate. For example, the ICA permits the SEC to commence criminal and administrative proceedings parallel to those in the Investment Advisers Act. *See* ICA §§ 9 and 48, 15 U.S.C. §§ 80a-9, 80a-47. The SEC may initiate civil en-

[4] For recent examples, *see In re Shearson Lehman Massachusetts Municipals*, Investment Company Act Rel. No. 88-213 (November 4, 1988) (exemption order authorizing reorganization of affiliated funds); *In re Mutual of America Life Insurance Company*, Investment Company Act Rel. No. 88-190 (October 3, 1988) (same).

[5] The task is also enormous, in an industry with 3,305 active registered investment companies, more than 12,690 active advisers, and some $1,200 billion assets under management. *See* 1987 Annual Report, U.S. Securities and Exchange Commission, at 49 (1988).

forcement actions in which to seek equitable relief, *see* ICA § 42, 15 U.S.C. § 80a-41, and, in appropriate cases, may suspend or revoke an investment company's registration, *see* ICA § 8(e), 15 U.S.C. § 80a-8(e).

Nor is it likely under the statutory scheme that a transaction otherwise subject to Section 17(a) could escape the Commission's detection. Pursuant to the authority granted by Section 31(b) of the ICA, 15 U.S.C. § 80a-30(b), the SEC conducts frequent inspections of the books and records of mutual funds, which would reveal a violation of Section 17(a). In 1987 alone, the Commission conducted more than 2,000 inspections or examinations of mutual funds and their advisers.[6] Substantial transactions—such as the sale of Narragansett's assets to Monarch—are likewise subject to SEC review notwithstanding Section 17(b). Indeed, in Narragansett's case, the asset sale was approved by security holders who based their decision on a description of the transaction embodied in a proxy statement that was filed with, and reviewed by, the SEC.[7] Whether pursuant to an application for exemption under Section 17(b) then, or in the ordinary course of its regulatory work, the SEC will inevitably encounter transactions within the scope of Section 17(a). By constructing an elaborate machinery for enforcing the ICA in general, and by specifically granting the SEC power to negate the strictures of the statute through Section 17(b) exemption orders, it is evident that Congress intended to vest exclusive and plenary authority for enforcement of Section 17(a) in the SEC.

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[6] *See* 1987 Annual Report, U.S. Securities and Exchange Commission, at 49 (1988).

[7] Not only was the sale of assets fully described in a disclosure document filed with the Commission, but as the First Circuit itself noted, it followed a prior proposed transaction that was presented to the Commission for an exemption order under Section 17(b). The plaintiff—who under Section 40(c), 15 U.S.C. § 80a-39(c), could and did appear as a representative of interested security holders—opposed the earlier plan and it was withdrawn. *See* 857 F.2d at 867 and page A-3 of the Appendix, *infra*.

In conferring multiple enforcement mechanisms for violations of Section 17(a) on the SEC, Congress obliged the Commission to exercise an informed discretion that is consistent with the legislative intention to guard against abuse while still authorizing appropriate transactions. Thus, when confronted with an application under Section 17(b) for an exemption order, the SEC necessarily must undertake a three-pronged inquiry. First, it must determine whether the proposed transaction is in fact within the reach of Section 17(a): Is it a transaction between an affiliate and a fund? Second, the Commission must determine whether the proposal would constitute a violation: Does the proposal involve the "purchase" of the fund's "property" by the adviser "acting as principal?" Finally, if the foregoing questions are resolved in the affirmative, the statutorily mandated scrutiny of the deal's substance must be made: Is it fair, consistent with the Act and compatible with the fund's objective? Similarly, even when an exemption order is *not* sought, the same three-pronged inquiry attends administrative or judicial enforcement of Section 17(a) by the Commission. The SEC cannot exercise its discretion to seek an injunction against a violation of Section 17(a) until it decides that a transaction has been undertaken that is within the measure's scope, that breaches its terms, and that warrants enforcement.

Incalculable mischief results if the same questions over which the SEC is required to exercise discretion—and act, or not act—are also presented to a court by a private litigant. Subjecting a mutual fund and its adviser to multiple inquiries of redundant questions—before the Commission and before a court—poses the risk that the answers will be inconsistent. To illustrate, the SEC might issue an exemption order or decline to prosecute because it determines that a "purchase" of fund "property"—say in a sale, merger of reorganization—is fair, reasonable and in the best interests of security holders. By virtue of an implied right of action, a transaction that the

Commission has expressly authorized pursuant to its statutory authority would be subject to collateral attack by a single shareholder who disagreed with the SEC's judgment.[8] Moreover, the mischief that results from the potential for inconsistency may be compounded when the SEC's resolution of the essential questions remains undisclosed. An exemption order may be granted, for example, or enforcement not pursued, because the Commission decides that a proposed transaction is not even within the ambit of Section 17(a); and the SEC may not reach the remaining issues. A court examining the same transaction would lack the benefit of the SEC's expertise, and might conclude that a violation exists. The danger that lurks in a system that exposes the SEC's expert judgment to collateral attack, in derogation of the confidence reposed in the agency by Congress, is self-evident.

As Justice Powell[9] cautioned in his dissent in *Merrill, Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353 (1982):

> "[M]odern federal regulatory statutes tend to be exceedingly complex. Especially in this context, courts should recognize that intricate policy calculations are necessary to decide when new enforcement measures are desirable additions to a particular regulatory structure. Judicial creation of private rights of action is as likely to disrupt as to assist the functioning of the regulatory schemes developed by Congress. *See, e.g., Universities Research Ass'n, Inc.* v. *Coutu*, 450 U.S. 754, 782-84 (1981)."

Curran, 456 U.S. at 408 (Powell, J., dissenting). *See also Cannon* v. *University of Chicago*, 441 U.S. at 749 (Powell, J. dissenting) ("overlapping judicial and administrative enforcement of these policies inevitably will lead to conflicts and confusion"). Allowing the Court of Appeals' decision to stand will trespass on the SEC's expertise, and on its exclusive authority

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[8] *Cf. Collins* v. *S.E.C.*, 532 F.2d 584, 591 (8th Cir. 1976) (appeal by shareholder-intervenor from exemption order issued pursuant to Section 17(b)).

[9] Justice Powell's dissent was joined by Justices Rehnquist and O'Connor and by Chief Justice Burger.

to regulate conflicts of interest between mutual funds and their advisers. By subjecting transactions to multiple and potentially inconsistent determinations, and by authorizing suits for transactions declared *exempt* from Section 17(a), the creation of a private right of action will deprive investment companies of any semblance of certainty with respect to the strictures of that statute. That is not a result that Congress intended, that is practicable in any sense, or that this Court should tolerate.

II. The Dissonant Approaches of the Lower Courts to the Existence of an Implied Private Right of Action Under the Investment Company Act Should Be Resolved by This Court.

As noted above, in *Burks* v. *Lasker*, 441 U.S. 471, 476 (1979), this Court reserved until another day a decision on whether a private right of action should be implied under the Investment Company Act. After *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984), the question again remained open: the Court there resolved only whether the express cause of action for the SEC and security holders stated in Section 36(b) extended to investment companies themselves. Both before and after *Burks* and *Fox*, however, and both before and after this Court's body of decisions from *Cort* v. *Ash*, 422 U.S. 66 (1975) to *Curran*, the lower federal courts have exhibited markedly different attitudes toward the implication of private rights of action under the ICA. Some have simply assumed their existence; others have directly refused to imply a cause of action; and several have found the Act to be privately enforceable. The decisions are marked by a variable reliance on the *Cort* factors and on this Court's mandate to divine congressional intent expressed in *Touche Ross & Co.* v. *Redington*, 422 U.S. 560 (1979) and *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11 (1979). That variability confirms that the outcome of this case would depend on the forum in which it was decided.

The petitioners cannot and do not assert that the circuit courts have divided on the direct question of whether to imply a private right of action under Section 17(a). Nor, in view of the existence of Section 17(b), is that surprising. Only eight[10] cases disclosed by the petitioners' research have even dealt with a stockholder's claim of an alleged violation of Section 17(a); and until the First Circuit acted, only three[11]—in just one sentence each—even briefly addressed the availability of a private right of action under that provision. But the absence of a marked fissure between the courts does not indicate the absence of controversy. The dissonance that has attended the lower federal courts' fickle approach to private enforcement of the Investment Company Act in general, and of Section 17 in particular, warrants this Court's attention.

As this Court noted in *Burks*, several courts have held that a private cause of action exists under the ICA. *Burks* v. *Lasker*, 441 U.S. 471, 476 n. 5 (1979).[12] *But see Brouk* v. *Managed Funds*, 286 F.2d 901 (8th Cir. 1961) (refusing to imply private right of action).[13] The reasoning of these cases, however, is

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[10] *Grace* v. *Ludwig*, 484 F.2d 1261 (2d Cir.), *cert. denied*, 416 U.S. 905 (1973); *Blau* v. *Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Upson* v. *Otis*, 155 F.2d 606 (2d Cir. 1946); *Krome* v. *Merrill Lynch & Co.*, 637 F. Supp. 910 (S.D.N.Y. 1986); *Goodall* v. *Columbia Ventures, Inc.*, 374 F. Supp. 1324 (S.D.N.Y. 1974); *Bangor Punta Corp.* v. *Chris Craft Industries, Inc.*, 337 F. Supp. 1147 (S.D.N.Y. 1971); *Moses* v. *Burgin*, 316 F. Supp. (D. Mass. 1970), *aff'd in part and vacated in part*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); and *Entel* v. *Allen*, 270 F. Supp. 60 (S.D.N.Y. 1987).

[11] *Krome*, 637 F. Supp. at 919 ("A private right of action has been found to exist for this provision") (relying on *Goodall*); *Goodall*, 374 F. Supp. at 1328 ("There can be no doubt that the Investment Company Act supports a private right of action for damages") (relying on *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961)); *Entel*, 270 F. Supp. at 65 ("A violation of the provisions of the 1940 Act may give rise to civil liability") (citing *Bullock*).

[12] *See Moses* v. *Burgin*, 445 F.2d 369, 373 (1st Cir. 1971); *Esplin* v. *Hirschi*, 402 F.2d 94, 103 (10th Cir. 1968); *Herpich* v. *Wallace*, 430 F.2d 792, 815 (5th Cir. 1970); *Taussig* v. *Wellington Funds, Inc.*, 313 F.2d 472, 476 (3rd Cir. 1963).

[13] The Eighth Circuit changed its view of private enforceability after this Court's decision in *J. I. Case* v. *Borak*, 377 U.S. 426 (1964). *See Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783 (8th Cir. 1967).

suspect: they tended to rely on the discredited formula that implication was essential to the effectuation of the statute's purposes. *See, e.g., Esplin* v. *Hirschi*, 402 F.2d 94, 103 (10th Cir. 1968) (relying on *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432-33 (1964)). Such misplaced reliance on *Borak* was understandable; for the cases noted in *Burks* were all rendered prior to the shift from purpose to intent signalled in *Cort* v. *Ash*.

After *Cort* and its progeny, including *Transamerica*, the lower federal courts took alternate paths: some refused to imply a right, while others relied on earlier precedent, or purported to distinguish this Court's decisions. Thus, for example, in *Herm* v. *Stafford*, 663 F.2d 669, 685-86 (6th Cir. 1981) (on rehearing), the Sixth Circuit held that the ICA "does not create a private right of action for breach of fiduciary duties except in a limited situation not present here.... The broad language of *Transamerica* and the obvious similarities between the Investment Advisers' Act of 1940 and Investment Company Act of 1940 strongly support the view taken in our original opinion." The view expressed by the Sixth Circuit in *Herm* has been echoed elsewhere, including the Ninth Circuit. *See Admiralty Fund* v. *Hugh Johnson and Co.*, 677 F.2d 1297, 1300 n.4 (9th Cir. 1982) (suggesting in dictum that "applying the strict statutory construction approach dictated by the Supreme Court's recent decisions... the existence of aider and abetter liability under Section 17(a) of the Investment Company Act is doubtful") and *Pegasus Fund, Inc.* v. *Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980) ("it is doubtful that [Section 34(b) of the ICA] implies a private cause of action," citing *Transamerica*).

In sharp contrast to the fidelity to *Transamerica* exhibited by the Sixth and Ninth Circuits, the Second and Third Circuits have found implied private rights of action in the ICA. *Fogel* v. *Chestnutt*, 668 F.2d 100 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982); *Bancroft Convertible Fund, Inc.* v. *Zico Investment Holdings, Inc.*, 825 F.2d 731 (3d Cir. 1987). An examination of these decisions, however, reveals reasoning that cannot withstand scrutiny.

Fogel and *Bancroft* each identified two distinct indicia of congressional intent to approve private remedies under the ICA. Neither of these so-called indicia, however, can sustain the inference ascribed to them by these courts. First, the *Fogel* and *Bancroft* decisions both laid great emphasis on the fact that when Congress amended the ICA in 1970 and 1980, it left intact the implication of private remedies recognized or assumed in prior lower federal court decisions. *Cf. Merrill, Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 381 (1982) (existence of right of action part of "contemporary legal context" when Congress legislated). According to *Fogel* and *Bancroft*, this legislative inaction signals a congressional intent to preserve the implied rights of action that were already woven into the fabric of the law. *See Fogel*, 668 F.2d at 110-11; *Bancroft*, 825 F.2d at 731. This reasoning is flawed for two reasons. In the first place, it ignores this Court's caution that "implying a private right of action on the basis of congressional silence is a hazardous enterprise, at best." *Touche Ross*, 442 U.S. at 571. *Cf. Cannon*, 441 U.S. at 717 ("When Congress intends private litigants to have a cause of action to support their statutory rights, the far better course is for it to *specify* as much when it *creates* those rights") (emphasis added). Furthermore, the lower court cases cited in *Fogel* and referenced by implication in *Bancroft*[14] were all rendered *before* the landmark *Cort* v. *Ash* decision, where this Court contracted the implication doctrine. Given that the standards for implying private rights of action were made still more exacting in the wake of *Touche Ross* and *Transamerica*, no significance can rationally attach to Congress' failure to nullify what by then was already bad law. Indeed, it would be utterly nonsensical to conclude that congressional silence in the face

[14] *See Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961); *Taussig* v. *Wellington Fund, Inc.*, 313 F.2d 472 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963); *Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); and *Esplin* v. *Hirschi*, 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969).

of lower court decisions of dubious validity can somehow *enshrine* these very decisions as reflective of congressional intent—and thereby bind a Supreme Court that has already *rejected* the reasoning of such decisions in *Touche Ross* and *Transamerica*.

Second, the *Bancroft* court placed considerable emphasis on a tidbit of legislative history that accompanied the 1980 amendments to the Investment Company Act, and which purported to express Congress' approval of implied rights of action under the Act. *See Bancroft*, 825 F.2d at 735-36 (quoting H. Rep. No. 1341, 96th Cong., 2d Sess. 28-29, *reprinted in* 1980 U.S. Code Cong. & Admin. News 4800, 4810-110). Significantly, however, this House Report corresponded to amendments to the Small Business Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980), and in no way related to Section 17(a) of the ICA. Therefore, this legislative item is of no probative value in assessing the intent of the Congress which enacted Section 17(a) forty years earlier.[15] This Court has rightly admonished that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *Consumer Product Safety Comm'n* v. *GTE Sylvania, Inc.*, 447 U.S. 102, 117 (1980). Accordingly, reliance on ICA amendments that did not alter Section 17(a)—and on accompanying legislative history that is both precatory in nature and likewise unrelated to Section 17(a)—is misplaced for purposes of implying a private right of action.

The array of approaches to implication of private rights of action under the ICA evidenced by the Sixth and Ninth Circuits, on the one hand, and the Second and Third Circuits, on

[15] Furthermore, since the 1980 amendments did not reach section 17(a), and since the courts were *not* unanimous in their approach to implied rights under the ICA, no legislative intent to "preserve" an already recognized cause of action can be inferred from the 1980 amendments. *Contrast Merrill, Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 (1982), where the courts *were* uniform in implying a right and Congress had acted *before* this Court decided *Cort* v. *Ash*, 422 U.S. 66 (1975).

the other, has permeated the district courts as well. Since *Transamerica*, district courts have variously implied rights in numerous sections of the measure, or have rejected private enforcement of the Act altogether. *Compare Krome* v. *Merrill Lynch & Co., Inc.*, 637 F. Supp. 910, 917-20 (S.D.N.Y. 1986) (finding implied rights of action under Sections 7(a), 10(b), 15(a) and (b), 17(a), 22, 35 and 36 of the ICA) and *Jerozall* v. *Cash Reserve Management, Inc.* [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,019, at 94,824-25 (S.D.N.Y. 1982) (finding implied right under Section 15 of the ICA) *with Tarlov* v. *Paine Webber Cash Fund, Inc.*, 559 F. Supp. 429, 434-39 (D. Conn. 1983) (denying implied rights of action under Sections 1(b)(2), 15(a) and 36(a) of the ICA, relying on *Transamerica*); *M. J. Whitman & Co. Pension Plan* v. *American Financial Enterprises*, 552 F. Supp. 17, 22 (S.D. Ohio 1982) (denying implied right under Section 7 of the ICA); and *Phillips* v. *Kapp*, 87 F.R.D. 548, 549 (S.D.N.Y. 1980) (denying implied right of action under Sections 34 and 40(a) of the ICA).

The confusion engendered by such inconsistent approaches is self-evident. Further, these decisions confirm that the outcome of this case would have been different had it been decided elsewhere. The private enforceability of the Investment Company Act therefore requires the attention of this Court.

III. The Implication of a Private Right of Action Under Section 17 of the Investment Company Act Conflicts With Applicable Decisions of This Court.

The First Circuit's judgment can only be supported by a process of reasoning that this Court has clearly rejected. The First Circuit has strayed from the path of finding and applying *legislative* intent to the field of formulating its *own* views on the purpose of an enactment—an intoxicating detour that the applicable decisions of this Court forbid.

This Court has not yet expressly addressed the issue of implied private rights of action under the Investment Company Act, but has instead reserved its judgment on the issue. *Burks* v. *Lasker*, 446 U.S. 471 (1979).[16] Nevertheless, the decisions of this Court that instruct the lower federal courts' required mode of analysis for the implication of private rights of action should leave no room for ambiguity: since the question reduces to one of congressional intent, construction of the actual language of the statute with a single-minded eye on the legislature's objective is required. The First Circuit, however, disregarded that command. Its rationale for finding an implied right of action in Section 17(a) is flatly inconsistent with the prior decisions of this Court.

In *Cort* v. *Ash*, 422 U.S. 66 (1975), this Court established a restrictive standard for implying private rights of action. In *Cort*, a stockholder brought an action for damages for alleged violations of a criminal statute prohibiting corporations from making financial contributions in federal elections. In refusing to recognize an implied civil cause of action in favor of the shareholder, this Court announced a four-prong test to determine whether a private right of action should be implied from a federal statute. Under the *Cort* test, courts must examine (1) whether the plaintiff is a member of the class for whose benefit Congress passed the statute; (2) whether Congress intended, explicitly or implicitly, to create or deny a private remedy; (3) whether implication of the private right of action is consistent with the underlying purposes of the legislative scheme; and (4) whether the remedy is one traditionally relegated to state law and thus inappropriate if based solely on federal legislation. *Cort*, 422 U.S. at 78. This four-factor test signalled a dramatic shift—away from an inquiry into whether common law principles warranted implying a private

[16] *See also Daily Income Fund* v. *Fox*, 464 U.S. 523, 536 (1984), holding that express cause of action stated in Section 36(b) may be enforced by the Commission or by shareholders suing derivatively, but not by the fund.

action so as to fulfill some statutory *purpose*,[17] and towards an inquiry directed primarily to determining whether Congress *intended* a civil cause of action to exist. This shift clearly reflected the Court's constitutionally rooted concern that the fashioning of private rights of action was, in general, a matter of congressional rather than judicial responsibility.

Since *Cort*, the primacy of legislative intent in the evaluation of whether federal statutes confer private rights of action cannot be overstated. The Court has taken care to point out that the prongs of the *Cort* test were designed purely as instruments for divining congressional intent. *See Cannon* v. *University of Chicago*, 441 U.S. 677, 741 (1979).[18] And this Court has repeatedly emphasized that recognition of an implied right is a matter of construction that begins with the statutory language and is ultimately limited to determining whether Congress intended to create the asserted cause of action. *See Touche Ross & Co.* v. *Redington*, 422 U.S. 560, 568 (1979), and *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 15 (1979)[19]. *Touche Ross* and *Transamerica* thus held that consideration of the *Cort* criteria was incidental to the critical determination of congressional intent: "[t]he ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Conress enacted into law." *Touche Ross*, 422 U.S. at 578.[20] Indeed, in *Transamerica*, the Court

[17] *See J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432-33 (1964).

[18] "Before concluding that Congress *intended* to make a remedy available to a special class of litigants, a court must carefully analyze the four factors that *Cort* identifies as *indicative of such an intent.*" (emphasis added). *See also Texas Industries, Inc.* v. *Ratcliff Materials, Inc.*, 451 U.S. 630, 639 (1981) ("Congressional intent may be discerned by looking to" the *Cort* factors).

[19] *See also Thompson* v. *Thompson*, 108 S. Ct. 513, 516 (1988).

[20] This view—that it is a congressionally enacted *statute* rather than some judicially noticed *policy* which authorizes federal courts to grant private rights of action—finds perhaps clearest expression in Justice Rehnquist's concurrence in *Cannon:*

> "I think the approach of the Court, reflected in its analysis of the problem in this case [and other recent cases] is quite different from

discounted the intent of Congress other than as revealed in the language of the statute itself. Finding express provisions for judicial and administrative enforcement of Section 206 of the Investment Advisers Act, the Court employed a rule of statutory construction requiring courts to avoid reading remedies into statutes that already contain express remedies, and accordingly refused to add a private enforcement action to the remedial scheme provided by Congress. *Transamerica*, 444 U.S. at 19-20.

When viewed through the prism of congressional intent, the error of the First Circuit comes into sharp focus. With no supporting authority in either the Act's language or legislative history, the Court of Appeals implied a private right of action under Section 17(a) of the ICA through an analysis that conflicts with settled principles of statutory construction long endorsed by this Court. Indeed, the First Circuit specifically refused to follow *Transamerica*, and instead relied on authority that purported to distinguish that decision.

A proper analysis of the lower court's ruling must necessarily begin with its treatment of congressional intent. Of apparently no significance to the First Circuit was the fact that, as with Section 206 of the Investment Advisers Act, which this Court held in *Transamerica* does not authorize a private action, Section 17(a) of the Investment Company Act does not provide for a civil cause of action. Like Section 206, Section 17(a) "simply proscribes certain conduct, and does not in terms create or alter any civil liabilities." *Transamerica*, 444 U.S. at 19. In enacting Section 17(a), which makes certain activities "unlawful," Congress responded to difficulties encountered in convicting affiliated persons for self-dealing in the management of investment companies. *U.S.* v. *Deutsch*, 451 F.2d 98, 108 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019

> the analysis in earlier cases such as [*Borak*]. . . . The question of the existence of a private right of action is basically one of statutory construction." . . .

Cannon, 441 U.S. at 717 (Rehnquist, J., concurring). *But see Thompson* v. *Thompson*, 108 S. Ct. 513, 521 (Scalia, J., concurring) ("I am at a loss to imagine what congressional intent to create a private right of action might mean, if it does not mean that Congress had in mind the creation of a private right of action.").

(1972). There is no evidence that Congress also intended thereby to provide a private right of action for damages under Section 17(a). Therefore, inasmuch as Congress' meaning must in the first instance be sought in the language of its statutory enactment, *see Caminetti* v. *United States*, 242 U.S. 470, 485 (1917), the First Circuit's failure to so much as even *advert* to the terms of Section 17(a) confirms its failure to execute the mission of discerning congressional intent.

The First Circuit also disregarded the evidence of congressional intent that pervades the ICA. Had the First Circuit examined the statute's remedial scheme, it would have recognized that Congress therein provides a series of remedies —administrative *and* judicial—whose availability belies the conclusion that courts were meant to imply additional ones. Thus, regulation of conduct within the reach of Section 17(a) of the Act is expressly vested in the SEC by Section 17(b), 15 U.S.C. § 80a-17(b). By providing an administrative mechanism for evaluating transactions within the scope of Section 17(a), it is evident that Congress intended to vest in the SEC exclusive jurisdiction over alleged self-dealing. Moreover, to the extent that it opts *not* to exempt under Section 17(b) a transaction subject to Section 17(a)'s prohibition, the Commission may exercise its express enforcement power and sue to enjoin the violation. Section 42 of the Act confers upon the SEC the power—which in the statute appears exclusive—to seek equitable orders to enforce compliance with any provision of the ICA or rules promulgated thereunder. 15 U.S.C. § 80a-41.

Privately enforceable remedies also exist under the Act; but the First Circuit ignored them. Section 36(b), 15 U.S.C. § 80a-35(b), for example, grants security holders the right to attack excessive fees of an investment company's investment adviser. *See Daily Income Fund* v. *Fox*, 464 U.S. 523 (1984). Likewise, Section 30(f), 15 U.S.C. § 80a-29(f), by incorporating the duties and liabilities found in Section 16 of the

Exchange Act, 15 U.S.C. § 78p, authorizes shareholders to sue insiders on behalf of the investment company for short-swing profits in transactions in the company's shares. "[I]t is an elemental cannon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it." *Transamerica*, 444 U.S. at 19. The existence of these express private remedies militates against the conclusion that Congress intended courts to imply additional rights of action. For as this Court has stated, when a statutory section is "flanked by provisions of the [statute] that explicitly grant private causes of action," it is obvious that "when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly." *Touche Ross*, 442 U.S. at 571-72.

The First Circuit's opinion is altogether bereft of the analysis of congressional intent this Court has required for private right implication. It is therefore evident that the First Circuit strayed from the path of strict statutory construction illumined by this Court in implication decisions since *Cort* v. *Ash*. The need for consistency and predictability in securities law and in the mutual fund industry, and the strong federal interest in judicial economy, warrant current action from the Supreme Court. Further delay in the resolution of this issue will merely breed a new generation of private right of action decisions under Section 17(a) and other provisions of the ICA—many apt to rely reflexively on the erroenous ruling of the First Circuit. For these reasons, the Court should take this opportunity to set the law of private remedy implication back on its proper course.

Conclusion

For all of the foregoing reasons, this petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX

A-1

United States Court of Appeals
For the First Circuit

No. 88-1015.

RICHARD LESSLER,
PLAINTIFF, APPELLANT,

v.

ARTHUR D. LITTLE, ET AL.,
DEFENDANTS, APPELLEES.

HEARD JUNE 10, 1988.
DECIDED SEPT. 21, 1988.

Mordecai Rosenfeld, P.C. and *Alan E. Bandler, P.C.*, New York City, with whom Benjamin J. Stein, Amedeo C. Merolla and *Asquith, Merolla, Anderson, Ryan & Wiley*, Providence, R.I., were on brief for plaintiff, appellant.

Robert G. Flanders, Jr., with whom *Jeffrey C. Schreck, Robert Karmen, Flanders & Medeiros Inc., Paul V. Curcio, John Gyorgy*, and *Adler Pollock & Sheehan Inc.*, Providence, R.I., were on brief, for defendants, appellees Narragansett Capital Corp., William P. Considine, John M. Fox, Frederick G. Frost, III, Harlow W. Gage, Norman E. McCulloch, Jr., John R. Rockwell, Harvey J. Sarles, and Rosalie J. Wolf, Narragansett Management Corp., Arthur D. Little, Robert D. Manchester, Gregory P. Barber, Roger A. Vandenberg, Jonathan Nelson, and Geraldine M. McNulty.

John D. Donovan, Jr., with whom *Ann Pauly Michalik* and *Ropes & Gray*, Boston, Mass., were on brief, for defendant, appellee Monarch Capital Corp.

Before BOWNES AND BREYER, *Circuit Judges* and CAFFREY,* *Senior District Judge.*

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* Of the District of Massachusetts, sitting by designation.

BOWNES, *Circuit Judge.*

Richard Lessler appeals the dismissal of his complaint against Narragansett Capital Corporation (Narragansett), Narragansett Management Company (Management Company), Monarch Capital Corporation (Monarch) and various individual defendants who are officers and directors of Narragansett and Management Company. Lessler, as a shareholder of Narragansett and acting on behalf of all shareholders, challenged the sale of Narragansett's assets to Monarch under federal and state securities laws. Adopting the report and recommendation of the magistrate, the district court found that Lessler's complaint failed to state a claim upon which relief could be granted, Fed.R.Civ.P. 12(b)(6), and failed to plead fraud with particularity, Fed.R.Civ.P. 9(b). We affirm in part and reverse in part.

I. BACKGROUND

In reviewing the dismissal, we consider only those facts and allegations set forth in the complaint and must view them in the light most favorable to the plaintiff, Lessler. *Harper* v. *Cserr*, 544 F.2d 1121, 1122 (1st Cir. 1976); *see also Miree* v. *DeKalb County*, 433 U.S. 25, 27 n. 2, 97 S.Ct. 2490, 2492 n. 2, 53 L.Ed.2d 557 (1977). The "accepted rule" is that Lessler's complaint should be dismissed for failure to state claim only if it appears beyond doubt that Lessler can prove no set of facts which would entitle him to relief. *Conley* v. *Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 101-102, 2 L.Ed.2d 80 (1957); *Harper*, 544 F.2d at 1122.

Incorporated in Rhode Island, Narragansett was a closed-end investment company registered under the Investment Company Act of 1940. 15 U.S.C. §80a-1 *et seq.* Its shares were traded in the over-the-counter market. Management Company, a separate corporation, provided investment advice to Narragansett pursuant to a series of investment advisory contracts. Prior to the events here at issue, the individual defen-

dants in this action attempted to take Narragansett "private," arranging for the sale of Narragansett's assets to themselves and certain other individuals. Such a transaction, however, required approval of the Securities and Exchange Commission, and after Lessler and others opposed the transaction, the individual defendants withdrew the plan.

Subsequently, Narragansett management proposed the sale of Narragansett's assets to Monarch. A proxy statement dated September 19, 1986, was mailed to all shareholders, giving notice of a special shareholders meeting to be held on October 30, 1986, for the purpose of voting on the proposed sale. At the special meeting, the Narragansett shareholders voted to approve. Under the terms of the sale to Monarch, Narragansett shareholders received fifty-five dollars in cash plus approximately one dollar in tax credits for each share of stock owned.

The Monarch-Narragansett agreement also provides that Monarch, which is not a registered investment company, will continue to employ Management Company as its investment adviser. For its services, Management Company will receive a management fee of two percent plus a potential additional one percent based on performance. Management Company will also receive a special fee of twenty percent of the cumulative net profit that Monarch realizes from the disposition of any assets it purchased from Narragansett.

Claiming that the special twenty percent contingent fee effectively constitutes an ownership interest by Management Company in Monarch, and thus in Narragansett, Lessler filed a putative class action on behalf of all Narragansett shareholders in United States District Court for the District of Rhode Island. Lessler's complaint has three counts, based respectively on alleged violations of the Investment Company Act, the Securities Exchange Act of 1934 (1934 Act) and Rhode Island state corporation law.

Lessler argues first that the Monarch-Narragansett transaction violates section 17(a)(2) of the Investment Company act, which prohibits any "affiliated person" knowingly from purchasing the assets of a registered investment company.[1] 15 U.S.C. §80a-17(a)(2). Management Company and the individual defendants are concededly "affiliated persons" of Narragansett, *see* 15 U.S.C. §80a-2(a)(2)-(3), and Lessler claims that Management Company through the sale to Monarch has itself indirectly purchased assets of Narragansett. *See* 15 U.S.C. §80a-47(a) ("It shall be unlawful for any persons, directly or indirectly, to cause to be done any act or thing through means of any other person which it would be unlawful for such persons to do under the provisions of this subchapter.") Lessler also alleges that the twenty percent contingent fee constitutes an excessive advisory fee in violation of section 36(b) of the Investment Company Act. 15 U.S.C. §80a-35(b).[2] Because of the alleged violations of sec-

[1] Section 17(a) provides in pertinent part:

> It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company . . ., or any affiliated person of such person, promoter, or principal underwriter, acting as principal—
>
> * * *
>
> (2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property . . . .

[2] Section 36(b) provides in pertinent part:

> For purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the [Securities and Exchange] Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, . . . for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.

tion 17(a)(2) and 36(b), Lessler seeks the following relief under the Investment Company Act: (1) rescission of the Monarch-Narragansett sale contract under section 47(b)(1), 15 U.S.C. §80a-46(b)(1);[3] (2) recovery of the excessive advisory fee under section 36(b), 15 U.S.C. §80a-35(b), and/or an injunction preventing enforcement of the advisory contract; and (3) recovery against the individual defendants for unjust enrichment pursuant to section 47(b)(3)(B), 15 U.S.C. §80a-46 (b)(3)(B) ("This subsection shall not apply . . . to preclude recovery against any person for unjust enrichment.").

Lessler's 1934 Act claim arises under sections 10(b) and 14(a), 15 U.S.C. §§ 78j(b) & 78n(a), and rules 10b-5 and 14a-9 of the Securities and Exchange Commission. 17 C.F.R. §§ 240.10b-5 & 240.14a-9.[4] It relates primarily to Narragan-

[3] Section 47(b)(1) provides in pertinent part:

> A contract that is made, or whose performance involves, a violation of this subchapter . . . is unenforceable by either party . . . unless a court finds that under the circumstances enforcement would produce a more equitable result than nonenforcement and would not be inconsistent with the purposes of this subchapter.

[4] Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 14(a) provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security

sett's proxy statement. Lessler claims that the proxy statement was materially false and misleading in that it characterized Management Company's contract with Monarch as a legitimate investment advisory contract rather than as "a guise and a sham to conceal the true fact that the Management [Company and individual defendants] are diverting to themselves assets of [Narragansett] that belong to all the shareholders." Amended and Supplemental Complaint at 11.

Lessler's state law claim alleges a breach of fiduciary duty by the individual defendants in approving a sale which "diverted" twenty percent of Narragansett's assets to Management Company. Amended and Supplemental Complaint at 17. As a result of this breach, Lessler asserts, Narragansett shareholders received less than the full and fair price for their

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(other than an exempted security) registered pursuant to section 781 of this title.

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 14a-9 provides in pertinent part:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false and misleading.

shares in the sale to Monarch. Lessler also argues that Monarch is liable under state law as an aider and abettor of the other defendants in their breach of fiduciary duty.

All defendants moved to dismiss Lessler's complaint and the motions were referred to the magistrate by the district court. The magistrate recommended that Lessler's complaint be dismissed in its entirety. *Lessler* v. *Little*, No. 86-0639P (D.R.I. Sept. 29, 1987) (Report). With respect to Lessler's Investment Company Act claims, the magistrate drew a bright line distinction between the sale of Narragansett's assets to Monarch and the advisory agreement between Monarch and Management Company, which he characterized as "[i]ndependent of and subsequent to" the purchase. Report at 3. Noting that only Management Company and not Monarch was an "affiliated person," the magistrate held that, considered in isolation, Narragansett's sale to Monarch was not a violation of section 17(a)(2). The magistrate also found that Monarch's contingent compensation arrangement with Management Company did not "as a matter of law transform [Management Company] into [a purchaser] of Narragansett property" because the compensation agreement was entered into after Monarch, an independent company, purchased Narragansett's assets. Report at 8.

In support of his recommended dismissal of Lessler's claim under section 36(b), the magistrate cited the following statutory exception to section 36(b) suits: "This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title. . . ." 15 U.S.C. §80a-35(b)(4). Notwithstanding the magistrate's prior conclusion that the Monarch-Narragansett transaction was *not* a purchase governed by section 17(a)(2), the magistrate found that Lessler's section 36(b) claim fell within this exception and thus failed to state a claim. Report at 9-10. Because he found that Lessler had no claims under section 17(a)(2) and 36(b), the magistrate also recommended

dismissing Lessler's claims under sections 47(b) and 48(a), which the magistrate described as "purely remedial" provisions not creating substantive rights. Report at 10-12.

The magistrate recommended dismissing Lessler's 1934 Act claim on the basis of Rule 9(b) of the Federal Rules of Civil Procedure, which requires that allegations of fraud be "stated with particularity." Relying on three opinions of this court, the magistrate described Lessler's section 10(b) and 14(a) allegations as insufficient and "totally in conclusional form." Report at 14-15 (citing *Hayduk* v. *Lanna*, 775 F.2d 441 (1st Cir. 1985); *Wayne Investment, Inc.* v. *Gulf Oil Corp.*, 739 F.2d 11 (1st Cir. 1984); *McGinty* v. *Beranger Volkswagen, Inc.*, 633 F.2d 226 (1st Cir. 1980)). Finally, the magistrate recommended that Lessler's state law claims be dismissed as well because Lessler's failure adequately to state any claim under federal law deprived the court of a basis for asserting pendent federal jurisdiction. Report at 16-17.

On November 19, 1987, the district court accepted the magistrate's report and recommendation in its entirety and entered judgment dismissing Lessler's complaint on the merits.

II. Investment Company Act Claims

As the Supreme Court has noted, "[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest." ***Burks*** v. ***Lasker***, 441 U.S. 471, 481, 99 S.Ct. 1831, 1838, 60 L.Ed.2d 404 (1979) (quoting *Galfand* v. *Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976)). "[A] typical fund is organized by its investment adviser which provides it with almost all management services. . . . [A] mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." *Id.* (quoting S.Rep. No. 184, 91st Cong. at 5 (1969)). In enacting the Investment Company Act of

1940, Congress was aware of this potential conflict of interest and was also concerned by "reports of 'fantastic abuse of trust by investment company management and wholesale victimizing of security holders.' " *United States* v. *Smolar*, 557 F.2d 13, 20 (1st Cir.) (quoting *United States* v. *Deutsch*, 451 F.2d 98, 108 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019, 92 S.Ct. 682, 30 L.Ed.2d 667 (1972)), *cert. denied*, 434 U.S. 866, 966, 971, 98 S.Ct. 203, 508, 523, 54 L.Ed.2d 143, 453, 461 (1977). The Act was "designed primarily to correct [such] abuses of self-dealing which had produced injury to stockholders of investment companies." *Id.*

The regulatory scheme embodied in the Investment Company Act scheme carefully controls the relationship between investment advisers and investment companies. It limits the number of persons affiliated with the adviser who may serve on the investment company's board of directors, 15 U.S.C. §80a-10, it requires that fees for investment advice and other services be governed by a written contract approved both by the directors and the shareholders of the investment company, 15 U.S.C. §80a-15, and it strictly regulates most transactions between investment companies and their advisers. 15 U.S.C. §80a-17. *See Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536-37, 104 S.Ct. 831, 838-39, 78 L.Ed.2d 645 (1984). Lessler's claim that he and other shareholders were harmed by self-dealing on behalf of Management Company thus falls squarely within the scope of concerns addressed by the Investment Company Act.

Nevertheless, raising an issue not addressed by the magistrate, the defendants assert a threshold defense to Lessler's invocation of the Investment Company Act, at least with regard to sections other than 36(b).[5] They argue that the Investment Company Act generally may not be enforced by

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[5] Section 36(b), by its very terms, extends a private cause of action to security holders in order to challenge breaches of fiduciary duty by investment advisers with respect to compensation. *See* note 2 *supra*.

private parties like Lessler. Relying principally on *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), defendants point to Congress' failure explicitly to create private rights under sections like 17(a)(2) while at the same time providing for administrative enforcement and criminal penalties, *see* 15 U.S.C. §§ 80a-35(a), 80a-41, 80a-48, and urge that this legislative scheme conclusively illustrates Congress' intent not to create a private cause of action. We do not agree.

At the outset, we must express our surprise that none of the defendants has cited, let alone discussed, this court's decision in *Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961, 85 S.Ct. 649, 13 L.Ed.2d 556 (1965), where an implied private cause of action under the Investment Company Act was found, at least in the context of a shareholder derivative suit. *See also Moses* v. *Burgin*, 445 F.2d 369, 373 & n. 7 (1st Cir.) (finding an implied private cause of action under section 36 of the Investment Company Act as it existed prior to the 1970 amendments in which Congress made explicit that such a private cause of action exists), *cert. denied*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971). We recognize, of course, that *Levitt* and *Moses* were decided before *Cort* v. *Ash*, 422 U.S. 66, 95 S.Ct. 2080, 45 L.Ed.2d 26 (1975), and later cases in which the Supreme Court imposed new constraints on the implication of private causes of action. *E.g.*, *Transamerica*, 444 U.S. 11, 100 S.Ct. 242; *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979). But two post-*Cort* court of appeals decisions have both distinguished *Transamerica* and held that causes of action implied under the Investment Company Act survive that decision. *Bancroft Convertible Fund, Inc.* v. *Zico Investment Holdings, Inc.*, 825 F.2d 731 (3d Cir. 1987); *Fogel* v. *Chestnutt*, 668 F.2d 100 (2d Cir. 1981), *cert. denied*, 459 U.S. 828, 103 S.Ct. 65, 74 L.Ed.2d 66 (1982). The defendants also have failed to cite or discuss these cases whose reasoning we find compelling.

In *Fogel*, stockholders of a mutual fund brought a derivative action against an investment adviser and several affiliated directors based on the failure of the adviser to take action to recapture certain brokerage commissions. The district court dismissed the stockholders' suit on the merits, but the Second Circuit, assuming that there was a private cause of action under the Investment Company Act, reversed and remanded for a computation of damages. *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975) (*Fogel I*), *cert. denied*, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976); *see Schwartz* v. *Eaton*, 264 F.2d 195, 198 n. 5 (2nd Cir. 1959) (finding a private cause of action under the Investment Company Act); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961) (same). After remand, the case returned to the Second Circuit where the defendants claimed, among other things, that cases like *Transamerica* compelled the conclusion that no implied private causes of action exist under the statute. In a thoughtful and thorough opinion by Judge Friendly, the Second Circuit rejected that argument. *Fogel* v. *Chestnutt*, 668 F.2d 100 (2d Cir. 1981) (*Fogel II*), *cert. denied*, 459 U.S. 828, 103 S.Ct. 65, 74 L.Ed.2d 66 (1982). Judge Friendly distinguished *Transamerica*, which dealt with a companion statute, the Investment Advisers Act, from the Investment Company Act on the following basis.

> In contrast to the three court of appeals decisions, all of very recent date, *see* [*Transamerica*,] 444 U.S. at 14 n. 4 [100 S.Ct. at 244 n. 4], sustaining the availability of a private cause of action under the Investment Advisers Act, the cases in the courts of appeals upholding the private cause of action for damages for violation of the [Investment Company Act] go back to our decision in *Brown* v. *Bullock*, *supra*, in 1961, and include the Third Circuit's 1963 decision in *Taussig* v. *Wellington Fund, Inc.*, 313 F.2d 472, 476, *cert. denied*, 374 U.S. 806 [83 S.Ct. 1693, 10 L.Ed.2d 1031] (1963); the First Circuit's 1964 decision in *Levitt* v. *Johnson*, 334 F.2d 815 (1964),

> *cert. denied*, 379 U.S. 961 [85 S.Ct. 649, 13 L.Ed.2d 556] (1965); the Tenth Circuit's 1968 decision in *Esplin* v. *Hirschi*, 402 F.2d 94, 103 (1968), *cert. denied*, 394 U.S. 928 [89 S.Ct. 1194, 22 L.Ed.2d 459] (1969), and numerous other decisions of the courts of appeals. . . .

Fogel II, 668 F.2d at 110. Judge Friendly found it significant that this line of cases had survived subsequent amendment of the statute in 1970, and refuted convincingly the notion that the express right of action created in 1970 under section 36(b) reasonably could be interpreted to negate the implied causes of action previously found by the courts of appeals. *Id.* at 111-12.

Building on *Fogel II*, the Third Circuit in *Bancroft* reached a similar conclusion. Its treatment of the issue is instructive.

> We need not repeat Judge Friendly's *Fogel* v. *Chestnutt* analysis here. We do note, however, that it is consistent with the analysis made a short time later by the Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 [102 S.Ct. 1825, 72 L.Ed.2d 182] (1982). In *Curran*, the Court considered whether there is an implied private right of action for enforcement of the Commodities Exchange Act (CEA). After many courts of appeals had so held, Congress amended the CEA in 1974 and 1978, but neither the original act nor the amendments addressed the subject of private judicial remedies. The *Curran* Court, stating that the crucial issue was whether Congress, in amending the CEA, intended to preserve pre-existing implied remedies, reasoned:
>
> > In determining whether a private cause of action is implicit in a federal statutory scheme when the statute by its terms is silent on that issue, the initial focus must be on the state of the law at the time the [amending] legislation was enacted. More precisely, we must examine Congress' perception of the law

> that it was shaping or reshaping. When Congress enacts new legislation, the question is whether Congress intended to create a private remedy as a supplement to the express enforcement provisions of the statute. When Congress acts in a statutory context in which an implied private remedy has already been recognized by the courts, however, the inquiry is logically different. Congress need not have intended to create a new remedy, since one already existed; the question is whether Congress intended to preserve the existing remedy.
>
> *Id.* at 378-79 [102 S.Ct. at 1839] (footnote omitted). Noting that prior to the amendments, federal courts routinely and consistently recognized an implied cause of action under the CEA, the *Curran* Court concluded that an implied cause of action under the CEA was, therefore, part of the "contemporary legal context" in which Congress acted in amending the Act. *See id.* at 381 [102 S.Ct. at 1840]. . . . Therefore, the *Curran* Court held, the prior law on implied causes of action for enforcement of the statute survived.

We find *Fogel* v. *Chestnutt* persuasive authority and *Curran* controlling.

825 F.2d at 731. *See also Krinsk* v. *Fund Asset Management, Inc.*, 654 F.Supp. 1227, 1230-34 (S.D.N.Y. 1987) (relying on *Fogel II* to imply a cause of action under the Investment Company Act); *Saylor* v. *Bastedo*, 100 F.R.D. 44, 52-53 (S.D.N.Y. 1983)(same). The Third Circuit noted that the implied private cause of action under the Investment Company Act had survived two sets of extensive congressional amendments, the first in 1970 and the second in 1980. In the case of the latter amendments, the legislative history accompanying the amendments explicitly stated that Congress intended the courts to continue implying private causes of action under the Investment Company Act "where the plaintiff falls within the class

of persons protected by the statutory right in question." *Id.* at 735-36 (quoting H.Rep. No. 1341, 96th Cong., 2d Sess. 28-29, *reprinted in* 1980 U.S. Code Cong. & Admin. News 4800, 4810-11).

[1] We agree with the Second and Third Circuits that it is consistent with congressional intent and with governing law to imply a private cause of action under the Investment Company Act. Moreover, as already stated, we think it clear that Lessler is within the class of persons intended to be protected by the Investment Company Act in general, and particularly section 17(a)(2) upon which he principally relies. We therefore reject the defendants' threshold argument and move on to consider the merits of Lessler's claims under the Investment Company Act.

[2] Section 17(a)(2), in essence, prohibits investment advisers and persons affiliated with such advisers from purchasing the assets of a registered investment company. *See* note 1 *supra*. Lessler argues that Management Company and the individual defendants, who are affiliated persons, have purchased such assets, at least indirectly, by arranging for the sale of Narragansett to Monarch in conjunction with an arrangement whereby Management Company obtained a twenty percent interest in the profits to be made on former Narragansett assets now owned by Management Company. Defendants would have us reject this claim by adopting the overly technical analysis of the magistrate which segregated the Monarch-Management Company fee arrangement from the Narragansett-Monarch sale. This distorts the complaint. There is no basis in Lessler's complaint for the magistrate's conclusion that the two transactions are "independent." To the contrary, the gist of the complaint is that, while the two transactions are separate on their faces, they are in fact components of a single deal.

Especially in light of section 48(a), which makes it unlawful to do indirectly that which one could not do directly, we

believe that if Lessler can prove that the two transactions are related in the way he alleges, he will have a valid claim under section 17(a)(2). To hold otherwise would elevate form over substance and ignore the broad remedial purposes of the Act; it would allow the defendants, simply by structuring a deal in two parts, to immunize their plan from judicial scrutiny under the Investment Company Act. *See United States* v. *Smolar*, 557 F.2d 13, 20 (1st Cir.) (rejecting an "unduly restrictive" interpretation of section 17(a) because "it would make the task of regulation impossible"), *cert. denied*, 434 U.S. 866, 966, 971, 98 S.Ct. 203, 508, 523, 54 L.Ed.2d 143, 453, 461 (1977). Since it is prohibited by the Act for Management Company directly to purchase Narragansett assets, we fail to see why the Act could not also reach Management Company's attempt to achieve the same result through the more circuitous route of selling Narragansett to a third party while itself retaining an interest (in the form of an excessive contingent advisory fee) in Narragansett assets.

Of course, in order to succeed, Lessler will also need to prove that the twenty percent contingent fee (in addition to the two to three percent annual management fee) is indeed, under the circumstances, so excessive as an investment advisory fee as to constitute an onwership interest by Management Company in the assets managed.[6] But Lessler is entitled to his day in court to attempt to prove exactly that. Accordingly, the district court's dismissal of Lessler's section 17(a)(2) claim must be reversed and the issue remanded for further proceedings.

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[6] Defendants have argued that we should hold, as a matter of law, that a twenty percent contingent fee arrangement is permissible under the statute and thus could never amount to an ownership interest. Brief of Defendants-Appellees at 14; Monarch Brief at 8 n. 6 (both citing section 205 of the Investment Advisers Act, 15 U.S.C. §80b-5, which permits compensation *up to* twenty percent in some circumstances). The statute does not, however, say that a twenty percent fee is always reasonable, and we think that the reasonableness of any fee must be evaluated under the specific facts and circumstances of a given case. On the meager record before us on this motion to dismiss, no such evaluation is possible.

[3] Section 36(b)(4) of the Investment Company Act makes it clear that rights and remedies under section 17 and section 36(b) are intended to be mutually exclusive. It provides that section 36(b) "shall not apply to compensation or payments made in connection with transactions subject to section 80a-17. . . ." 15 U.S.C. §80a-35(b)(4). Since we have held that Lessler's complaint does state a claim under section 17(a)(2), it therefore follows that his complaint does not also state a claim under section 36(b). In addition, even if the transaction involved here was not "subject to" section 17, Lessler's section 36(b) claim would fail for another reason. Section 36(b) provides shareholders with a cause of action for compensation "paid" to an investment adviser in violation of the adviser's fiduciary duty. *See* note 2 *supra*. Here, however, the disputed compensation is the twenty percent contingent fee, and Lessler does not allege that any part of that fee has yet been paid by Monarch to Management Company. Lessler therefore can point to no cognizable loss under section 36(b) upon which to sue. The district court's dismissal of Lessler's section 36(b) claim is affirmed.

[4] Lessler's final Investment Company Act claim is his request for rescission of the Narragansett-Monarch sale contract under section 47(b)(1), and his related request for unjust enrichment recovery under section 47(b)(3). In this claim, Lessler appears to have overlooked the plain language of the very statutory section he invokes. Section 47(b)(1) declares that contracts entered into in violation of the other provisions of the Investment Company Act are "unenforceable *by either party*." 15 U.S.C. §80a-46(b)(1) (emphasis added). Lessler is not a party to the Narragansett-Monarch contract, nor does his complaint assert a derivative action on behalf of Narragansett, which is a party. Lessler proceeds solely on his own behalf as a shareholder and on behalf of others similarly situated. As our previous decisions have made clear, a shareholder such as Lessler lacks standing to pursue on his own claims properly belonging to the corporation. *E.g., In re Dein Host, Inc.*, 835 F.2d 402, 405-06 (1st Cir. 1987). The dismissal of Lessler's section 47 claim was proper.

III. 1934 Act Claims

[5] Although Lessler asserts claims under two sections of the 1934 Act he concedes that, in order to succeed under either his section 10(b) or section 14(a) claims, he must prove that the defendants are responsible for some material misrepresentation or material omission concerning the sale of Narragansett to Monarch. Lessler Brief at 28. Because we believe that Lessler's complaint fails to allege any such misrepresentation or omission, we affirm the district court's dismissal on that ground without addressing the Rule 9(b) pleading issue relied upon by the magistrate.

It is important to note first that the only statements identified by Lessler's complaint that are allegedly false and misleading are those contained in the September 19, 1986 proxy statement. Amended and Supplemental Complaint at 10-11. Moreover, as Lessler concedes, it is clear that the contested proxy statement did reveal the basic outline of the Narragansett-Monarch sale. The proxy statement discloses: (1) that certain of the individual defendants in this action are stockholders and/or directors and officers of Narragansett and Management Company; (2) that the defendants who are stockholders of Narragansett will, as part of the sale, receive from Monarch their pro rata payment for shares owned; and (3) that in addition Management Company, and thus its stockholders, will receive from Monarch an investment advisory fee of two to three percent annually plus twenty percent of all profits made by Monarch at the disposition of former Narragansett assets.

Lessler contends that, in spite of this disclosure, the proxy statement was materially false because of how it labeled the Monarch-Management Company deal: it described the arrangement as a bona fide advisory contract rather than as a "guise" or "sham" to divert Narragansett assets to Management Company. Lessler is, in essence, complaining about the wording and editorial presentation of the proxy statement, not its substance. Under established case law, this claim must fail.

The case most directly on point is *Golub* v. *PPD Corp.*, 576 F.2d 759 (8th Cir. 1978). In *Golub*, minority shareholders mounted a section 10(b) and section 14(a) challenge to the sale of a corporation's assets on the basis of an allegedly misleading proxy statement. In particular, the stockholders complained that the proxy statement described certain payments to top management personnel as bonuses for entering the employ of the purchasing corporation, when they were actually premiums to be paid on account of management's controlling stock ownership and willingness to make the sale of assets. The Eighth Circuit rejected the claim that the proxy statement was misleading in violation of the 1934 Act. Its analysis bears repeating:

> As far as proxy statements are concerned, and regardless of whether the question arises in a suit brought under § 14(a) or (e) and implementing rules or whether it arises in a suit based on § 10(b) and Rule 10b-5, the federal purpose is served if the statement fully and fairly sets out such relevant and material facts as would enable a reasonably prudent stockholder to make an intelligent decision as to whether to grant the requested proxy or as to how he should vote on the questions mentioned in the proxy statement.
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> * * *
>
> Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited. This design has special relevance to merger transactions that, under state law, must be subjected to shareholder approval. In the context of such transactions, if federal law ensures that shareholder approval is fairly sought and freely given, the principal federal interest is at an end. Underlying questions of the wisdom of such transactions or even the fairness become tangential at best to federal regulation.
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> * * *

> Actually, the plaintiffs are not complaining about any absence of facts in the proxy statement. Their complaint is that those who prepared the statement did not "disclose" what the plaintiffs say was the true motivation of [management] in selling assets of the company, and did not characterize the bonus aspect of the transactions as plaintiffs would have it characterized. Under the Act and regulations, plaintiffs were not entitled to have such a "disclosure" or such a characterization.

Id. at 762-63 (citations omitted) (quoting *Popkin* v. *Bishop*, 464 F.2d 714, 719-20 (2d Cir. 1972) (citations omitted). *See also Kas* v. *Financial General Bankshares, Inc.*, 796 F.2d 508, 517 (D.C. Cir. 1986) ("The federal securities laws require only that the various roles of [interested officers and directors] be clearly disclosed—as they were. The defendants need not label or editorialize on the disclosed facts, at least where the potential conflict of interest would be obvious to any reasonable shareholder.") (citing *Golub*); *Data Probe Acquisition Corp.* v. *Datalab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983) ("[T]he proxy materials sent . . . described the guarantees of employment negotiated by [interested directors] and thus disclosed their conflict of interest. We see no additional informational benefit accruing to shareholders by requiring the beneficiaries of such contracts to announce that they regard them favorably . . . The disclosure required by the Act is not a rite of confession or exercise in common law pleading. What is required is the disclosure of material objective factual matters."), *cert. denied*, 465 U.S. 1052, 104 S.Ct. 1326, 79 L.Ed.2d 722 (1984); *Valley National Bank* v. *Trustee for Westgate-California Corp.*, 609 F.2d 1274, 1282 (9th Cir. 1979) ("As to . . . inadequate disclosure of conflicting interests among the directors and trustees—it should be noted that no one contends that the information was undisclosed . . . . The sole claim is that the information was "buried" in the information statement and thus did not give adequate notice of potential conflicts. We

disagree. . . . the [plaintiffs] may wish to have seen the potential conflicts appear [in a different part of the statement], but they cite no authority which would require this textual organization."), *cert. denied*, 444 U.S. 1015, 100 S.Ct. 667, 62 L.Ed.2d 645 (1980).

Here Narragansett did disclose all of the relevant *factual* details concerning the Narragansett-Monarch sale, including the now-disputed twenty percent contingent fee to be paid by Monarch to Management Company. Through this disclosure, reasonably intelligent shareholders were made aware of the substance of the proposed transaction. Indeed, Lessler's complaint, in which the central factual allegations are simply restatements of facts contained in the proxy statement, demonstrates that shareholders could "see through" management's characterization of Management Company's twenty percent interest as an investment advisory fee. Lessler has no grounds under the 1934 Act for complaining about managements' choice of words.[7] The district court's dismissal of Lessler's 1934 Act claims is affirmed.

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[7] In defense of his 1934 Act claims, Lessler relies heavily on the district court opinion in *Hahn* v. *Breed*, 587 F.Supp. 1369 (S.D.N.Y. 1984). Lessler claims that the court in *Hahn* upheld a section 10(b) and section 14(a) claim solely on the ground that a proxy statement mischaracterizes the true purpose of payments to the trustee of a business trust. *Hahn*, however, is distinguishable from this case in that the plaintiffs there also challenged a specific factual representation in the proxy statement, namely, that no discussion concerning a consulting agreement had taken place while merger terms were being negotiated. 587 F.Supp. at 1374-75. Moreover, to the extent that the holding in *Hahn* goes beyond that distinction, and purports to rest a 1934 Act claim solely on the basis of the labels used to describe a payment which was otherwise fully disclosed factually, it is a district court opinion that is inconsistent with circuit court precedent (including the opinion of the Court of Appeals for the Second Circuit, in which the district court sits, *see Data Probe*, 722 F.2d at 5-6) and it is not entitled to deference by this court. *See also* cases cited *supra* at 875-876.

IV. State Law Claims

Without discussing their merits, the district court dismissed Lessler's state law claims on jurisdictional grounds. The court reasoned that because all of Lessler's federal claims had been dismissed before trial, a federal court should not exercise pendent federal jurisdiction over his state law claims. Report at 16 (citing *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725-26, 86 S.Ct. 1130, 1138-39, 16 L.Ed.2d 218 (1966)). We have, however, determined that Lessler's claim under section 17(a)(2) of the Investment Company Act should not have been dismissed. Accordingly, on remand the district court should reconsider whether in its discretion, Lessler's state law claims now merit the assertion of federal jurisdiction.

V. Conclusion

The district court's judgment dismissing Lessler's claims under sections 36(b) and 47 of the Investment Company Act and sections 10(b) and 14(a) of the 1934 Act are affirmed. The dismissal of Lessler's claims under section 17(a)(2) of the Investment Company Act is reversed. The case is remanded for further proceedings consistent with this opinion.

No costs on appeal.

United States Court of Appeals
For the First Circuit

No. 88-1015

RICHARD LESSLER,
PLAINTIFF, APPELLANT,

v.

ARTHUR D. LITTLE, ET AL.,
DEFENDANTS, APPELLEES.

JUDGMENT
ENTERED: SEPTEMBER 21, 1988

This cause came on to be heard on appeal from the United States District Court for the District of Rhode Island, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The district court's judgment dismissing Lessler's claims under sections 36(b) and 47 of the Investment Company Act and sections 10(b) and 14(a) of the 1934 Act are affirmed.

The dismissal of Lessler's claims under section 17(a)(2) of the Investment Company's Act is reversed and the cause is remanded to the district court for further proceedings consistent with the opinion filed this day.

No cost on appeal.

By the Court:
FRANCIS P. SCIGLIANO, *Clerk.*
[cc: Rosenfeld, Flanders, Jr., and Donovan, Jr.]

MAGISTRATE'S REPORT AND RECOMMENDATION

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF RHODE ISLAND

C.A. No. 86-0639P

RICHARD LESSLER

v.

ARTHUR D. LITTLE ET AL.

REPORT AND RECOMMENDATION

HAGOPIAN, Magistrate.

The instant matter has been referred to the United States Magistrate for consideration pursuant to Title 28 U.S.C. §636(b)(1)(A) or (B).

Before the Court is defendants' motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) and 9(b) on the ground that plaintiff has failed to state a claim upon which relief can be granted and has failed to plead fraud with particularity. The instant motion is brought on behalf of all defendants except Monarch Capital Corporation.

Plaintiff in the instant matter has filed a Three Count Amended complaint which adds one party (Monarch Capital Corporation) and drops another (Raymond J. Armstrong) including the addition of a new claim under 47(b) of the Investment Company Act. Title 15 U.S.C. §80a-1 *et seq.*

In the First Count, plaintiff alleges the defendants have violated Sections 17(a)(2), 36(b), 47(b) and 48(a) of the Investment Company Act of 1940 ("1940 Act"). In the Second Count, plaintiff alleges that defendants (except Monarch) have violated Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 ("1934 Act"). In the Third Count, plaintiff claims that defendants have breached certain laws of the State of Rhode Island.

Before the Court is defendants' motion to dismiss the plaintiff's amended complaint in its entirety pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim and in addition plaintiff's claim under Sections 10(b) and 14(a) of the 1934 Act for failure to plead fraud with the particularity required by Federal Rule 9(b). Defendant Monarch Capital Corporation has filed a separate motion to dismiss pursuant to Federal Rule 12(b)(6) for failure to state a claim.

Statement of Facts

Plaintiff, a shareholder of the Narragansett Capital Corporation (Narragansett), brings the instant suit as a "class action. . . on behalf of all other persons (other than the defendants and persons affiliated with them) who were shareholders of Narragansett at the time its assets were sold to Monarch Capital Corporation."

The defendants to the instant action are as follows:

(1) Narragansett is an investment company registered under the 1940 Act.

(2) The Management Group defendants, Little, Manchester, Barber, Vendenberg, Nelson and McNulty were the directors of Narragansett. In addition to being directors of the corporation, the Management Group defendants were at all relevant times and still are the sole stockholders and principal officers of a separate company, defendant Narragansett Management Company (Management Company). The Management Company has acted as the investment advisor to Narragansett.

(3) Monarch purchased all the assets of Narragansett in a transaction which is the subject of the instant litigation.

On October 30, 1986, Narragansett shareholders overwhelmingly approved the asset sale and liquidation plan described in a September 19, 1986 Proxy Statement. Accordingly, the interest of all Narragansett shareholders were liquidated to Monarch in exchange for approximately $55 in cash

plus federal income tax credits of $1 per share. Independent of and subsequent to its agreement to purchase Narragansett, Monarch also entered into a separate investment advisory contract with the Management Company pursuant to which Monarch had agreed to compensate Management Company for future investment advisory services. The Compensation Agreement includes the potential for a contingent fee calculated as 20% of Monarch's cumulative net profits from the holding and disposition of the assets which Monarch has acquired from Narragansett. Monarch has also agreed to pay Management Company a management fee of 2% of the value of the Narragansett assets held by Monarch plus a potential 1% based on performance.

The gravamen of plaintiff's amended complaint is that the Management Group defendants have fashioned a contract whereby they and they alone will participate in the profits generated by the future sale of Narragansett's assets, and thus the shareholders of Narragansett were asked to sell their shares at an unfair, depressed price caused by wilful fraud and illegal activity of the Management Group defendants. Plaintiff appears to allege that, by virtue of Management Company's Advisory Agreement with Monarch, the Management Group defendants are responsible for an unfair, depressed, price offered for the shares.

Finally, the amended complaint alleges that:

> . . .[t]he proxy statement is materially false and misleading in that it does not set forth fairly or clearly the facts that:
>
> (a) Narragansett's properties are worth substantially in excess of $56 per share;
> (b) The Management Group defendants know that Narragansett's properties are worth substantially in excess of $56 per share;
> (c) The Management Group defendants will benefit to the extent the price paid by Monarch is lower;

(d) The Advisory Agreement is unenforceable and void under the law. . .;

(e) The Advisory Agreement is but a guise and a sham to conceal the true fact that the individual defendants are diverting to themselves assets of Narragansett that belong to all the shareholders.

Discussion

A complaint should not be dismissed pursuant to Rule 12(b)(6) Federal Rule of Civil Procedure for failure to state a claim upon which relief can be granted unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley* v. *Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102; *accord*, *H. K. Porter Co., Inc.* v. *Nicholson File Co.*, 353 F. Supp. 153, 159-160 (D.R.I. 1973); *Harper* v. *Cserr*, 544 F.2d 1121, 1122 (1st Cir. 1976). The question must be resolved in the light most favorable to the plaintiff with any doubt resolved in his behalf. *Jenkins* v. *McKeithen*, 395 U.S. 411, 89 S.Ct. 1843 (1969); *Klimas* v. *International Tel. and Tel. Corp.*, 297 F. Supp. 937 (D.R.I. 1969). Accordingly, the Court must deny a motion to dismiss if the allegations of the complaint permit relief to be granted on any theory, even one not expressly stated therein. *Adams* v. *Bell*, 711 F.2d 161, 187 (D.C. Cir. 1983), *cert. denied*, __ U.S. __, 104 S.Ct. 1272 (1984).

Count I

Sections 17(a)(2), 36(b), 47(b) and 48(a) of the Investment Company Act of 1940, 15 U.S.C.A. Section 80a-1 *et seq*. Section 17(a)(2).

Plaintiff in Count I first alleges that defendants (other than Monarch) violated Section 17(a)(2) of the 1940 Act which in relevant part provides:

> (A) It shall be unlawful for any affiliated person . . . of . . . a registered investment company . . . or any affiliated person of such a person, . . . acting as principal . . .
>
> (2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer).

Plaintiff argues that the individual defendants through the advisory agreement with Monarch became part owners with the same of Narragansett's assets. Thus, plaintiff urges that the defendant (other than Monarch) are "affiliated persons" of Narragansett within the meaning of Section 17(a)(2). Plaintiff's assertions are misplaced. My reasons are these.

Section 17(a)(3) of the 1940 Act defined "affiliated persons" as follows:

> (3) "Affiliated" person of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlling, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly, controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

It is undisputed that the contract for the asset purchase was between Monarch and Narragansett. The duties under the Advisory Contract entered into between the Management Group defendants (who also owned the Management Company) and Monarch was that the former would render advisory services to the latter in return for a fee calculated as a percentage of the net profits received by Monarch.

At the time of the sale between Narragansett and Monarch, the Management Group defendants' interest in Narragansett discontinued. Subsequently, the Management Group defendants entered into the Advisory Contract with Monarch. Under the terms of the Advisory Contract, the Management Group defendants would render future advisory services to Monarch in return for a fee calculated as a percentage of the net profits received by Monarch. It is at this juncture plaintiff urges that the Management Group defendants, via the Advisory Contract, are affiliated with Narragansett and a purchaser of Narragansett's assets.

I find the contingent compensation formula for future investment management services does not as a matter of law transform the Management Group defendants into purchases of Narragansett property or partners of Monarch under Section 17(a)(2). Here, the assets of Narragansett were purchased not by any affiliated person(s) but by Monarch, an independent insurance holding company. The Management Group defendants entered into the advisory agreement with Monarch after the latter had already purchased the assets from Narragansett.

Accordingly, I find that plaintiff's Section 17 claim against all defendants should be dismissed as a matter of law for it fails to state a claim upon which relief can be granted in that plaintiff can prove no set of facts to support his allegations thereof.

Section 36(b) of the Investment Company Act

Plaintiff alleges that the Management Group defendants and Monarch violated Section 36(b) by their purchase of Narragansett's assets at an unfair price, through the guise of the investment advisory contract. Plaintiff urges that although the 20% advisory fee will be paid by Monarch to the individual defendants at a later date, it is being paid by the plaintiff now because they are necessarily receiving less than they would receive were the 20% clause deleted. I disagree. My reasons are these.

Subparagraph 4 of §36(b) provides:

> This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title...

Plaintiff's Section 36 claim describes a transaction which is subject to the prohibitions of Title 15 U.S.C. §17(a)(2) (making it unlawful to knowingly purchase property of a registered investment company).

In light of my finding that plaintiff's Section 17 claims against all defendants should be dismissed, I find plaintiff's Section 36(b) claim should fail.

Additionally, because Monarch is not an investment company, any payments made to the Management Group defendants for future investment advice cannot possibly implicate Section 36(b) which, by its terms, applied only to payments made by a registered investment company or its shareholders. Thus, I find that the plaintiff's Section 36(b) claims asserted against all defendants should be dismissed for failure to state a claim upon which relief can be granted.

Section 48(a) of the 1940 Act

In ¶22 of the amended complaint, plaintiff alleges that:

> . . . [A]ll of the defendants are also in violation of Section 48(a) of the Investment Company Act by causing, through the proposed sale to Monarch and the (Advisory Agreement), a sale and transfer of an interest in the Corporation's property to the Management Group Defendants since such a sale or transfer, if done directly, would violate Sections 17(a)(2) and 47(b) of the Investment Company Act.

However, plaintiff's reliance on Section 48(a) is misplaced. Section 48(a) provides:

> It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this subchapter or any rule, regulation, or order thereunder.

Stated more succinctly, Section 48(a) "makes it unlawful to do 'through or by means of any other person' that which it would be unlawful for the person to do directly." *Monheit* v. *Carter*, 376 F.Supp. 334, 341 (S.D.N.Y. 1974).

Standing alone, Section 48(a) does not prohibit any particular act or make unlawful any specific activities. Section 48 creates no substantive rights and is purely remedial in nature. Since I find that no defendant has violated any of the substantive provisions of the 1940 Act, I find that plaintiff cannot rely on Section 48(a).

Section 47(a) of the 1940 Act

Plaintiff alleges that the defendants have violated Sections 17(a)(2), 48(a), and 36(b) of the 1940 Act, and that the Advisory Agreement is consequently void and unenforceable under Section 47(b) of the 1940 Act, Title 15 U.S.C. §80a-46(b)(1).

Section 46(b)(1) provides:

> . . . a contract that is made, or whose performance involves, a violation of this subchapter, or of any rule, regulation, or order thereunder is unenforceable by either party (or by a nonparty to the contract who acquired a right under the contract with knowledge of the facts by reason by which the making or performance violated or would violate any provision of this subchapter or any rule, regulation or order thereunder) unless a court finds that under the circumstances enforcement would produce a more equitable result than nonenforcement and would not be inconsistent with the purpose of this subchapter.

Section 47(a) creates no separate cause of action and is addressed only to the remedies a Court may employ to fashion relief once a cause of action has been stated under a substantive provision of the 1940 Act. In light of my finding that plaintiff has failed to demonstrate a violation of Section 17(a)(2) or Section 36(b) by defendants, I find that plaintiff cannot invoke the remedial provisions of Section 47(a) of the 1940 Act.

Count II

(Sections 10(b), 10(b)(5), 14(a), 14a-(9) of the 1934 Act)

Plaintiff, in Count II of the amended complaint, alleges that defendants (except Monarch) violated Section 10(b) of the 1934 Act and Rule 10b-5 thereunder "because plaintiff and the class he represents are being caused to receive less than their shares of Narragansett are worth in the sale to Monarch because of defendants' wilful device, scheme and artifice to defraud; because of defendants' wilful untrue statements; and because of defendants' wilful fraud and deceit."

In addition to the Section 10 claims, Count II also alleges violations of Sections 14(a) and 14a-(9). Specifically, plaintiff claims that the proxy statement sent to Narragansett's share-

holders is "materially false and misleading for each of the reasons set forth above. All that is alleged is that the Management Group defendants "know the true value" of Narragansett's assets and that such assets are worth more than the price being paid to Narragansett's shareholders; that the Management Group defendants would be benefited by a sale of Narragansett at this "depressed price" because they stand to benefit in the future if Narragansett's assets can be sold later at a profit; and that the Advisory Agreement is void, unenforceable, and a "guise and sham to conceal the true fact that the Management Group defendants are diverting to themselves assets of the Corporation that belong to all the shareholders."

Defendants move to dismiss Count II on the grounds that plaintiff has failed to plead the alleged fraud with the requisite particularity pursuant to Federal Rule of Civil Procedure 9(b), or in the alternative, on the grounds that Count II fails to state a claim upon which relief can be granted pursuant to Federal Rule 12(b)(6).

Rule 9(b) in the First Circuit

Wayne Investment, Inc. v. *Gulf Oil Corp.*, 739 F.2d 11 (1st Cir. 1984) and *McGinty* v. *Beranger Volkswagen, Inc.*, 633 F.2d 226 (1st Cir. 1980) clearly announces the law of the First Circuit as to the requisite specificity that a party alleging fraud must meet:

> It is well settled that Rule 9 "requires specification of the time, place, and content of an alleged false representation, but not the circumstances or evidence from which fraudulent intent could be inferred..."
>
> This special pleading requirement provides the defendant with notice of the grounds on which plaintiff's fraud claim rests... In addition, in the context of securities litigation, Rule 9 "operates to diminish the possibility

> that 'a plaintiff with a largely groundless claim (will be able) to simply take up the time of a number of other people (by extensive discovery), with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence. . .' " (*quoting Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741, 95 S.Ct. 1917, 1928, 44 L.Ed.2d 539 (1975)).

The Court in *Wayne Investment, Inc.* v. *Gulf Oil Corporation, supra*, recognized that a number of courts have held that allegations based on "information and belief" do not satisfy the particularity requirement unless the complaint sets forth the facts on which the belief is founded; that the requirement of supporting facts be pleaded applies even when the fraud relates to matters peculiarly within the knowledge of the opposing party.

In light of the preceding, I find that the defendants have demonstrated that the plaintiff has failed to allege his fraud claims with the requisite particularity. My reasons are these. Plaintiff, in alleging his Section 10 and Section 14 claims, does so totally in conclusional form. Although such averments recite all the elements under Sections 10 and 14, they are all based on information and belief and omit any facts in support thereof. Pleadings which are entirely conclusional and which make no reference to facts in support of the same, circumvent the special pleading requirement in providing the defendants with notice of the grounds on which plaintiff's claims of fraud rest. *See Blue Chip Stamps* v. *Manor Drug Stores, supra.* Count II fails to specify the time or content of the alleged wrongful acts.

Additionally, the First Circuit in *Hayduk* v. *Lanna*, 775 F.2d 441 (1st Cir. 1985), held that mere allegations of fraud, or referrals to plans and schemes as found in the instant complaint are too conclusional to satisfy Federal Rule 9(b).

Accordingly, I find that defendants' motion to dismiss Count II of plaintiff's amended complaint should be granted.

Plaintiff's Pendent State Law Claims

At this juncture, defendants urge that the pendent state law claims in Count III should be dismissed because no viable federal basis of jurisdiction exists. I agree.

Pendent Jurisdiction

Dispositive of the question of this Court's exercise of pendent jurisdiction over the plaintiff's alleged state claims against all the named defendants is the United States Supreme Court holding in *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725 (1966). *See also Aldinger* v. *Howard, Treasurer of Spokane County, et al.*, 96 S.Ct. 2413, 2419, 427 U.S. 1, 49 L.Ed.2d 276. In *United Mine Workers*, the Supreme Court held that federal court's exercise of pendent jurisdiction is appropriate when there is a substantial federal claim and the relationship between it and the state claim derive from a common nucleus of operative facts. However, pendent jurisdiction is discretionary and "if the federal claims are dismissed before trial . . . the state claim should be dismissed as well." *Id.* at 726.

I find that the defendants have demonstrated that the plaintiff can prove no set of facts in support of his federal claims.

Accordingly, in light of my recommendation to dismiss all of plaintiff's federal claims, I must recommend that the plaintiff's state law claims also be dismissed.

Recommendation

Defendant Monarch's motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) and the motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) and 9(b) submitted by all remaining defendants should be granted. Plaintiff's amended complaint in its entirety should be dismissed. I so recommend to the Court.

/s/ JACOB HAGOPIAN
JACOB HAGOPIAN
United States Magistrate
September 29, 1987

ANY OBJECTIONS TO THIS REPORT AND RECOMMENDATION MUST BE SPECIFIC AND MUST BE FILED WITH THE CLERK OF COURT WITHIN (10) DAYS OF RECEIPT OF THIS REPORT. FAILURE TO FILE SPECIFIC OBJECTIONS WITHIN THE SPECIFIED TIME WAIVES THE RIGHT TO APPEAL THE DISTRICT COURT'S ORDER.

ORDER ACCEPTING THE MAGISTRATE'S REPORT.

DISTRICT COURT OF THE UNITED STATES
FOR THE DISTRICT OF RHODE ISLAND

C.A. No. 86-0639P

RICHARD LESSLER

v.

ARTHUR D. LITTLE ET AL.

ORDER

The Report and Recommendation of United States Magistrate Jacob Hagopian filed on September 29, 1987 in the above-captioned matter is accepted pursuant to 28 U.S.C. §636(b)(1).

By Order,
/s/ PAULETTE J. DUBE
Deputy Clerk

Enter:
/s/ RAYMOND J. PETTINE
RAYMOND J. PETTINE
Senior U.S. District Judge

November 19, 1987

FINAL JUDGMENT.

RECEIVED
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CLERK
U.S. DISTRICT COURT
DISTRICT OF RHODE ISLAND

UNITED STATES DISTRICT COURT
DISTRICT OF RHODE ISLAND

C.A. No. 86-0639P

RICHARD LESSLER
PLAINTIFF,

v.

ARTHUR D. LITTLE *et als.*
DEFENDANTS.

JUDGMENT

This action came on for decision by the Court, Senior Judge Raymond F. Pettine presiding, with respect to defendants' Motion to Dismiss the Complaint under Rules 12(b)(6) and 9(b) of the Federal Rules of Civil Procedure, and pursuant to the Order of this Court dated November 19, 1987 and the Report and Recommendation of the Magistrate dated September 29, 1987, it is hereby

ORDERED AND ADJUDGED:

That the plaintiff take nothing, that plaintiff's action and his Amended Complaint be dismissed on the merits, and that the defendants recover of plaintiff their costs of action.

By Order,
/s/ (ILLEGIBLE), Deputy Clerk

Enter:

/s/ RAYMOND J. PETTINE
Senior Judge

Dated: 12/3/87